

NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

YEAR 2000

**REVIEW OF CREDIT UNION
LIQUIDITY PLANS**

OIG-99-09 December 9, 1999



REPORT BY:

**NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL**

YEAR 2000

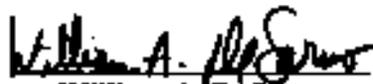
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OIG-99-09 December 8, 1999

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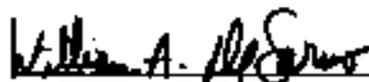

William A. DeSarno
for Frank Thomas
Inspector General

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Introduction

This is the fifth of the Office of Inspector General's (OIG) series of reports addressing the Year 2000 (Y2K) computer problem as it relates to the National Credit Union Administration (NCUA) and federally insured credit unions (FICUs). This report addresses steps that NCUA has taken to address emergency Y2K liquidity issues and our review of natural person credit unions liquidity plans.

Because of the time critical nature of the Y2K problem, and in order to provide the NCUA Board with timely information, we are not making formal recommendations or asking for a written response. Rather, we are offering certain suggested actions as matters for consideration by the NCUA Board and agency management in this management report.

Another OIG report in process will address the Y2K readiness status of credit union vendors.

Background

As we get closer to December 31, 1999, concerns have been raised over a potential increase in liquidity and cash demand. These demands could be the result of media stories, movies, public perception, Y2K related system failures, or a combination of factors. No one knows for sure whether there will be a liquidity emergency, how long it will last, or when it will happen.

Because of this uncertainty, the Federal Reserve, financial regulatory agencies such as NCUA, and other organizations have prepared plans and taken action to deal with a potential liquidity emergency. For example, the Federal Reserve printed an additional \$50 billion to cover potential cash demands of the public; and NCUA worked with Congress to temporarily lift the Central Liquidity Facility (CLF) borrowing limitation which creates an additional \$20 billion in liquidity available to credit unions. These are just a couple of examples of preparations being taken to prevent or minimize any potential liquidity problems near the century date change.

The Y2K liquidity issue can be broken into two areas: liquidity and cash demand. Liquidity planning deals with managing the credit union's assets and liabilities to ensure that the credit union can continue to fund all of its normal operations, including member cash needs. Cash demand deals with the ability to have sufficient cash on hand to meet member needs by ensuring sufficient cash supplies, cash transportation, and adequate physical security.

Although steps have been taken to increase liquidity and cash availability, financial regulatory agencies and credit union trade organizations have encouraged each financial institution to prepare a liquidity plan to ensure they can meet the needs of their customers or members. In order to mitigate the liquidity risks credit unions face due to the Y2K problem, NCUA required all of its federally insured credit unions to prepare liquidity plans by June 30, 1999.

Objectives

Our specific review objectives were: (a) to determine if NCUA has taken a proactive role to address emergency liquidity issues and minimize disruption at the credit unions it oversees; and (b) to determine if natural person credit unions have adequate plans to address Y2K liquidity issues.

Scope and Methodology

To meet our first objective, we reviewed guidance issued by NCUA to credit unions and examiners; compared NCUA's guidance to guidance issued by other financial regulators and trade organizations; gained a basic understanding of liquidity sources available to the credit union industry; and interviewed personnel from the Central Office, Region IV, and Region VI.

To meet our second objective, we reviewed a sample of liquidity plans from natural person credit unions. Our sample was selected from two of NCUA's six regions - Region IV and Region VI. We selected a random sample of 60 credit unions representing 10 small, 10 medium, and 10 large natural person credit unions from each region. All of the plans requested were available, except for two. We did not review these two plans because they were in the process of merging with another credit union. Our review was limited to documentation available from the examiner at the time of our request in July 1999. We did not perform any follow-up work with the examiner, supervisory examiner, or credit unions.

We identified critical attributes and reviewed a sample of natural person credit union liquidity plans to determine if these critical attributes were incorporated in the plans. To identify critical attributes, we selected certain minimum attributes included in NCUA's guidance. In addition, we felt that identifying triggers was an important attribute so we also included it as a critical attribute. These critical attributes include:

- liquidity plan was readily available;
- liquidity and cash needs were estimated and reasonable;
- liquidity funding sources have been identified and contacted;
- triggers were identified;
- security issues were considered; and
- plan provided for frequent monitoring.

We performed a limited review of the liquidity and cash needs analysis. Our review was limited to spot checking these analyses for noticeable errors in assumptions and calculations. We also determined if the examiner evaluated the plan and provided feedback to the credit union.

Our observations are based on the documentation available at the time of our request and follow-up interviews with regional office personnel. We presented our observations to regional office and central office personnel to obtain their comments. They agreed with our observations and have implemented our suggestions.

We began our review in June 1999 and completed fieldwork in October 1999. Because of the limited review scope and our desire to provide NCUA management with timely information, we followed the President's Council on Integrity and Efficiency Quality Standards for Inspections with the exception of the standards for fraud and other illegal acts and follow-up.

OBSERVATIONS

There is an abundance of liquidity available to fund any potential liquidity emergencies at credit unions. The credit union industry has various sources, including but not limited to, internal assets, other financial institutions, corporate credit unions, U.S. Central, the Federal Home Loan Bank, the Central Liquidity Facility, and three Federal Reserve options. Figure 1 below shows some of the external liquidity sources available to credit unions, as well as the sources available to corporate credit unions, U.S. Central, and the Central Liquidity Facility.

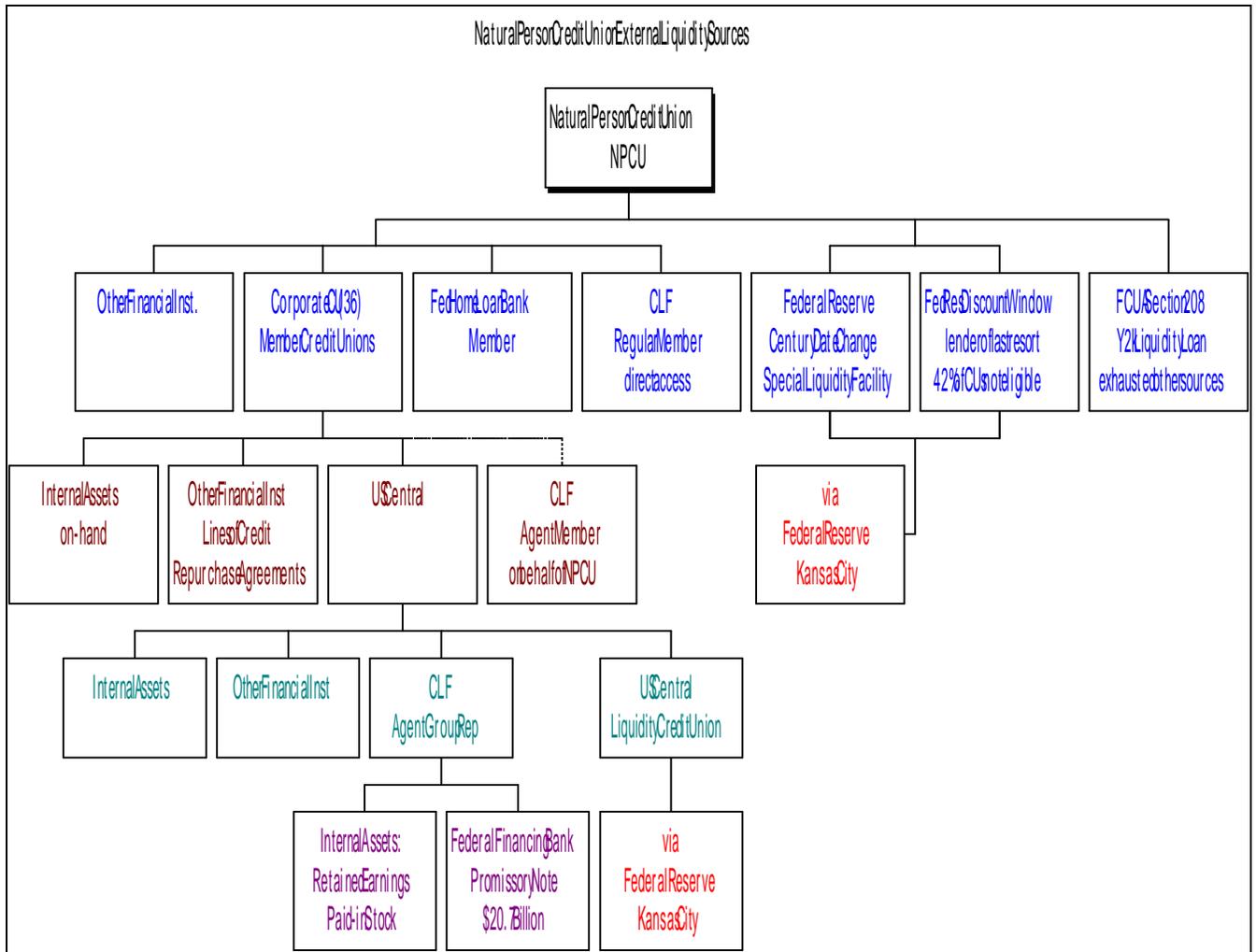


Figure 1

NCUA has taken appropriate action to address and minimize potential liquidity emergencies as a result of the century date change. Some of these actions include working with Congress to temporarily lift the CLF borrowing limitation, issuing guidance to credit unions and examiners, requiring credit unions to prepare liquidity plans, and promoting public awareness.

We reviewed a sample of liquidity plans and found that each credit union in our sample prepared a liquidity plan. The examiners review documentation indicated that most liquidity plans were reasonable and adequate. However, it was difficult to determine the degree of analysis performed by the examiner in determining the adequacy of the plans. Our review of the plans indicated that many of the critical attributes suggested in NCUA's guidance were missing and that there was much room for improvement with the plans. As a result of our observations, one of the regions indicated they would issue additional guidance to their examiners and perform a quality control review to ensure the plans were reviewed and, in fact, adequate.

Fortunately, credit unions still have a few weeks to continue to strengthen their plans in order to minimize any operational disruptions as a result of media hype or public hysteria near the century date change.

NCUA's actions to address Y2K Liquidity

In order to ensure the safety and soundness of the credit union system, NCUA has been proactive in addressing a potential increase in liquidity demand due to the century date change.

Some of the actions NCUA has taken to address liquidity concerns include: issuing guidance to credit unions; obtaining liquidity plans for each of the credit unions it oversees; facilitating additional liquidity; and promoting public awareness.

NCUA required each federally insured credit union to prepare a liquidity plan. NCUA issued thorough guidance to credit unions that contained useful tips and considerations when preparing their liquidity plans. In addition, NCUA created a database to track the completion and adequacy from each and every federally insured credit union. As of September 30, 1999, NCUA reported that all federally insured credit unions completed their liquidity plans except for one.

In addition, NCUA facilitated the availability of additional liquidity by working with Congress, the CLF, the Federal Reserve, and the Corporate Credit Union system. NCUA worked with Congress to temporarily lift the CLF borrowing limitation of \$600 million to over \$20 billion. NCUA streamlined the CLF lending process to expedite the loan approval process for the months around the century date change. U.S. Central Corporate Credit Union created a new facility, U.S. Central Liquidity Credit Union, which provides natural person credit unions additional access to the discount window of the Federal Reserve Bank of Kansas City.

In order to prevent unwarranted panic, NCUA has been very active in promoting public awareness of the Y2K issues. NCUA Board Members, management, and staff have conducted several press conferences and written many articles addressing Y2K.

OIG review of Liquidity Plans

Our review of liquidity plans gave us confidence that credit unions have been planning for potential Y2K related liquidity emergencies. We found that liquidity plans were readily

available, many credit unions indicated a line of credit was available without identifying specific sources, and many credit unions staggered investments with late 1999 maturity dates. However, these plans could be strengthened.

Of the 58 liquidity plans we reviewed, examiners indicated that 56 were adequate as of June 30, 1999. However, we found that only 5 of the 58 natural person credit union liquidity plans we reviewed included all the critical attributes identified in NCUA's guidance. The table below presents the summarized results of our review of the liquidity plans. Specifically, the table shows the percentage of liquidity plans in our sample that contained the critical attributes listed. For example 53 percent of the plans in our sample contained an estimate of liquidity needs.

Attribute	Percent
Liquidity plan provided	100
Examiner opinion indicated adequate plan	97
Estimated cash needs*	62
Examiner notes indicated review	60
Estimated liquidity needs	53
Considered security issues	41
Provided for frequent monitoring	38
Contacted liquidity funding sources	16
Identified liquidity funding sources	14
Identified triggers causing sources to be accessed	10
Incorporated minimum attributes per NCUA's guidance	9

* relative to 53 of the 58 plans sampled

In addition, we performed an analysis comparing the results for small, medium, and large natural person credit unions liquidity plans (See Appendix 1). Although this analysis concluded that the overall results were consistent regardless of the size of the credit union, it demonstrated that the larger credit unions were more proactive in estimating their liquidity and cash needs and preparing for security issues.

Many liquidity plans could be strengthened by incorporating the critical attributes listed below. During our review of liquidity plans, we identified some useful examples that credit unions have specified in their liquidity plan. As a result, we have included some excerpts from these plans that addressed the following critical attributes in Appendix 2:

- estimated liquidity and cash needs;
- reviewed liquidity sources;
- triggers for obtaining liquidity or cash have been identified and well defined;
- safety of employees and members has been considered if onsite cash is significantly increased; and
- plan provided for frequent monitoring.

Although we found many of these attributes missing from the sample of credit union liquidity plans we reviewed, this does not mean that the credit union will have liquidity problems. Because liquidity plans are living documents, the plans may have been revised to reflect some of these items since our review. If there is a liquidity emergency, a well developed plan incorporating these attributes will minimize any disruption.

We also observed some credit union policies that could lead to an unnecessary decline in member confidence if not communicated to members appropriately. These policies include:

- a holiday schedule that varies from normal operating procedures,
- and plans to limit member withdrawals.

If a credit union plans to change an operating policy that significantly affects its members, they should communicate the change to minimize any concern and disruption to their members. Subsequent to our review, NCUA issued a letter to credit unions (99-CU-16) that instructs credit unions to communicate to members any changes in operating hours.

In addition, we found that examiner documentation of their review was inconsistent. As of June 30, 1999, the database reflected that our sample of 58 plans were reviewed. However, in 23 of the 58 plans, there was no additional evidence that the plan was reviewed by the examiner or feedback was provided to the credit union. We did not consider the database as evidence of the examiners review since we found that many of the liquidity plans were rated adequate when we found that minimum attributes had not been addressed. Although it is possible the examiner reviewed the plan and provided feedback to the credit union, in many cases it was not apparent from the documentation we reviewed. We also noted several errors in the preparation of the liquidity needs analysis that did not appear to be detected by the examiner. For example, we observed mathematical errors and faulty assumptions in the liquidity and cash needs analysis where the database indicated the plan was “adequate” and no further review notes were included.

MATTERS FOR CONSIDERATION

The OIG is suggesting the following actions as matters for consideration by the NCUA Board and agency management:

1. NCUA should continue to review liquidity plans to ensure that:
 - critical attributes are considered in plan;
 - assumptions in liquidity and cash needs analysis are reasonable;
 - sufficient backup resources (cash and liquidity) are available to meet estimated needs;
 - significant changes in credit union policy are communicated to members; and
 - examiner review and feedback is documented.
2. NCUA should continue to follow-up on liquidity plans that are incomplete or rated inadequate.

Auditee Comments

We solicited feedback on the draft report from Regions IV and VI plus NCUA's Office of Examination and Insurance (E&I), Office of Corporate Credit Unions (OCCU), the Executive Director, and the Director of Strategic Planning. Both regions agreed with our observations and felt the report adequately summarized the agency's liquidity activity. In addition, the two regions stated they have already implemented our suggestions.

E&I and OCCU indicated that our report was an accurate summary of the liquidity process. However, E&I felt that our review was incomplete because we did not contact credit unions or interview examiners; and our review was based on documentation provided in July 1999.

OIG Response to Auditee Comments

We appreciate the comments provided by the regions and central offices and have made every effort to make clarifications in the report where necessary. Although we agree that performing interviews of examiners and credit unions would have provided us with additional information, we were unable to perform these interviews due to the time sensitivity of this issue and lack of resources. As a result, we have clearly presented this limitation in the scope section of our report. In addition, we briefed the regional offices on the results of our review during our field work in August 1999 and they agreed with our observations.

We realize that NCUA examiners may have performed additional follow-up and documentation after our fieldwork. However, we had to base our evaluation on the records and documentation available at the time of our review. Additional follow-up on our part at the examiner and credit union level would have lengthened the review process and prevented the issuance of our report in a timely manner.

APPENDIX 1**SUMMARY RESULTS OF NATURAL PERSON CREDIT UNION
LIQUIDITY PLAN REVIEW FOR
SMALL, MEDIUM, AND LARGE CREDIT UNIONS**

ATTRIBUTE	Small	Medium	Large	Total	Percentage
Liquidity plan provided	19	19	20	58/58	100%
Liquidity needs estimated	5	11	15	31/58	53%
Cash needs estimated	5	11	17	33/53	62%
Liquidity funding sources were identified	3	3	2	8/58	14%
Liquidity funding sources were contacted	4	2	3	9/58	16%
Identified triggers causing sources to be accessed	1	0	5	6/58	10%
Considered security issues	4	8	12	24/58	41%
Provided for frequent monitoring	6	7	9	22/58	38%
Incorporated minimum attributes per NCUA's guidance	2	1	2	5/58	9%
Examiner notes indicated review	10	12	13	35/58	60%
Examiner opinion indicated adequate plan	18	19	19	56/58	97%

NOTE:

Small credit unions are less than \$10 million

Medium credit unions are between \$10 and \$50 million

Large credit unions are greater than \$50 million

EXCERPTS FROM LIQUIDITY PLANS**ESTIMATE LIQUIDITY AND CASH NEEDS**

Despite the fact that a liquidity and cash needs analysis should be the basic starting point of a liquidity plan, approximately half of the plans did not incorporate a liquidity and cash needs analysis in its plans. There are various methods a financial institution can use to estimate its liquidity needs and each credit union needs to determine the best method for it to use. A few examples of methods we observed in our review include

- A worksheet developed by the collaborative efforts of CUNA Mutual Group, U.S. Central Credit Union, CUNA & Affiliates, and credit unions
- Historical analysis of liquidity and cash needs
- Estimate of probable, possible, and worst case scenario.

We observed that approximately two-thirds of the credit unions that did a liquidity analysis used the CUNA worksheet or a variation of the worksheet to estimate liquidity and cash needs. The CUNA worksheet considers the number of members per household; the number of households that use the credit union as its primary financial institutions; and the expected amount of withdrawal for both currency and noncurrency purchases. These factors assist in calculating the currency and noncurrency liquidity demand which is then compared to the excess cash and available liquidity at the credit union to determine the liquidity excess or shortfall. This worksheet also compares three estimates: best case, worst case, and most likely.

Credit unions that performed a historical analysis used different methodologies to determine its needs. For example, one credit union performed a five year analysis and noted that normal share withdrawals from October to December were higher than any other period. They used this to calculate its monthly baseline and added 20 percent, which was determined by communicating with its membership. Another credit union analyzed its transaction clearing accounts, determined the activity average with an increase of 20 percent, and then doubled this amount. One credit union determined currency needs by reviewing historical cash usage at the branch and ATM facilities to come up with a baseline cash demand. Then the credit union estimated the amount of additional Y2K cash demand by multiplying its primary financial institution members by \$500. The baseline cash demand was added to the additional cash demand.

Other methods we observed included calculating the total number of members by using social security number and multiplying this by an estimated per member withdrawal amount. One credit union estimated liquidity needs by calculating the anticipated Y2K funds needed and increasing by seasonal demands and an emergency fund. Its emergency fund was an additional 2 percent of estimated assets.

EXCERPTS FROM LIQUIDITY PLANS

REVIEW LIQUIDITY SOURCES

While 42 of the plans mentioned a line of credit was established, only 13 of the 58 plans we reviewed either identified the line of credit source or revealed that they had contacted its liquidity sources. It is critical that credit unions ensure they will have the ability to provide liquidity to its members when needed. Credit unions may need to access backup sources of liquidity if there is a liquidity emergency. To minimize the effect on operations, credit unions should:

- plan to have sufficient liquidity sources to cover a worst case scenario;
- contact liquidity sources to ensure they have the ability to provide adequate resources;
- take the necessary actions in case they need to obtain assistance from backup sources; and
- identify contact information for liquidity sources such as source name, key contact person, account numbers, amount available, etc.

The more detailed plans included the name of the source, contact person, phone number, account number, and amount available. However, in some instances, we could not tell if the credit union had sufficient backup sources because this information was not included in the plan.

IDENTIFY AND DEFINE TRIGGERS FOR OBTAINING LIQUIDITY AND CASH

Of the 58 plans reviewed, only three plans identified triggers for activating its plans. An additional three credit unions were in the process of identifying triggers. Each credit union needs to define its trigger points that will best meet its needs. Below are some examples of triggers three credit unions used.

One credit union will use a liquidity ratio to monitor its liquidity position. The liquidity ratio will be reported to the Board of Directors on a monthly basis. If the ratio reaches or exceeds 90 percent, its contingency liquidity plan will be activated. The flow of events in its contingency plan is to pledge mortgage backed securities and loans to the FHLB as collateral for an advance; draw funds from an unsecured line of credit at its corporate credit union; investigate selling investment securities; advertise for non-member deposits; and finally, request assistance from the CLF.

Another credit union identified a couple of situations that would trigger activation of its liquidity contingency plan and even alert to excess liquidity. These situations included: unfunded commitments decrease by 25 percent or more; share balances fall below 75 percent of total loans or rise above 150 percent of total loans; the liquidity/assets ratio falls below 6 percent or rises above 25 percent; or the loan/assets ratio falls below 35 percent or rises above 75 percent.

EXCERPTS FROM LIQUIDITY PLANS

**IDENTIFY AND DEFINE TRIGGERS FOR OBTAINING LIQUIDITY AND CASH
(continued)**

The third credit union identified a specific dollar amount of liquidity as its trigger point to activate its contingency plan. The contingency plan includes a couple of options that will be used, such as offering a special certificate program to members, obtaining an emergency deposit, or accessing an emergency line of credit with its corporate credit union.

CONSIDER SAFETY OF EMPLOYEES AND MEMBERS

We observed that 24 of the 58 credit unions in our sample considered security in its plan. Credit unions that have cash operations need to take security seriously. If a credit union plans to increase its onsite cash significantly, that presents an even stronger case for added security. But even if a credit union has not increased its cash holdings, the perception still remains that cash has been increased at most financial institutions. Some credit unions will conduct security and robbery training for its employees. The safety of employees and members should be a priority.

One credit union is taking extra precautionary measures to ensure employee safety and protection of credit union assets. They have taken steps to hire an armed security guard during working hours and additionally during nonworking hours if the alarm is not working. At midnight, December 31, 1999, credit union officials will determine if the power is working. If they determine the power is not working, they will notify the Police Department. In the event the power goes out, the credit union will continue to operate with the presence of an armed guard and doors will remain locked with no more than five members allowed in at a time.

One small credit union will send two people to pick up cash and stagger pickup times when the cash amount increases. Some larger credit unions will transport and deliver currency by armored car service. Some credit unions will contract with armored guards for added security in its branches. Other credit unions will have security guards on standby. These different methods are valid for the size and needs of the credit union. However, it is important that the credit union take the necessary action to ensure these options will be available when and if needed.